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The Manufacturers Hanover
Financial Digest
Weekly Commentary, Selected Financial Data, and Business Indicators

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The Diagnosis Is Right . . .

Those economists who have criticized President Reagan's economic talk can be divided into two camps. The first disagrees with his diagnosis of the state of the economy today, while the second criticizes his prescription to cure our ills. Some economists are in both camps, in that they don't think we are in such bad shape today and even if we were we could not get out of it by implementing the President's proposals. Others agree with his assessment, but might take issue with some of the specifics of his program.

From here, it would seem as though the President correctly identified the current economic situation as a "mess." To be sure, unemployment is nowhere near as high as it was during the Great Depression. However, interest rates are nowhere near as low as they were at that time because we have 12 per cent inflation today whereas prices actually fell during the early stages of the Depression. And lest anyone doubt that high rates of inflation and high interest rates can be worrisome, a look at the nation's two key industries, autos and housing, will dispel that very quickly.

After falling ten per cent in 1979, sales of domestically produced automobiles plunged almost 20 per cent last year to a 20-year low. Housing starts fell 14 per cent in 1979 and another 23 per cent in 1980. Countless numbers of homebuilders and new car dealers have gone out of business in the last couple of years and this is having a ripple effect on a great many industries in the U.S.

. . . But The Prescription Is Risky

As for the President's plan for dealing with this "mess," there is no quarrel with the idea of reducing taxes, especially those paid by business and investors. This is needed to stimulate capital formation and encourage spending on newer, more modern machinery and equipment so that productivity gains can arise. However, it would seem to be taking a big risk to cut taxes in the absence of dollar-for-dollar cuts in government spending. This is because the Federal budget is already running a deficit at an annual rate of close to $80 billion so far in the fiscal year (not counting off-budget government-sponsored agencies). Any cut in tax revenues without a commensurate cut in spending has as its immediate effect a widening of the deficit. In turn, this could result in either another inflationary burst of money growth or sharply rising interest rates and a possible credit squeeze. Neither of these developments would be conducive to ending our economic mess—indeed, they might even worsen it.

More rapid inflation would arise if the Federal Reserve expands the supply of money and credit to accommodate the increased demands that would flow from widening Washington's budget deficit. On the other hand, if the Fed does not become more accommodative, then Washington will simply borrow at the expense of the private sector, leaving less money available for small businesses and individuals. This could well produce yet another round of soaring interest rates, and a new credit squeeze.

Of course, one can question whether the President will be able to obtain cuts of any significant magnitude in government spending. This is because he would like to increase defense spending significantly, and a good chunk of nondefense spending is not controllable over a short period of time. Whatever cuts in government spending will occur can only come after the American people have made known their views to the Congress on their attitudes towards cutting government spending that directly benefits whatever special interest group to which they happen to belong. Here, the jury is still out, because the specifics of the President's plan to cut Federal spending will first be released next week.

Corporate Profits Remain Weak . . .

Despite the five per cent rise in the fourth quarter's "real" Gross National Product, corporate profits did not improve much. In fact, according to preliminary estimates, after-tax profits remained relatively flat, growing by only 0.2 per cent quarter-over-quarter. What is more, they were five per cent below the comparable quarter a year ago and almost 13 per cent less than their first quarter peak. The beneficial impact of an increased level of economic activity was almost completely offset by the rise in the cost of doing business, reflecting ongoing high rates of inflation, in general, and escalating labor, energy,

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and financing costs, in particular.

The high rate of inflation also had other negative effects. Put simply, ever-escalating prices caused inventory profits to be overstated and depreciation charge-offs understated. For example, inflation caused the market value of inventories to increase sharply, contributing significantly to profits. Similarly, depreciation charges typically valued plants and equipment at historical rather than current prices, thus causing depreciation allowances to understate the true cost of replacement. As a result, these accounting methods caused profits to include components which do not result from operations but rather from the fact that selling prices are posted at a later date than input prices. When inflation rates accelerate, these components expand; conversely, they tend to diminish when inflation wanes.

A more realistic way of measuring corporate profitability is by subtracting these unrealizable inventory profits and underdepreciation from book profits to obtain a true picture of earnings from operations. Although after-tax profits declined by less than 3.5 per cent in 1980 from the 1979 level, after these adjustments, operating profits fell by more than seven per cent. At $43.3 billion, the inventory valuation adjustment for 1980 was the largest for any year ever and so was the depreciation allowance at $18.1 billion. Furthermore, when inflation is taken into account—nine per cent as

Selected Federal Reserve Data

(Averages of Daily Figures—Billions of Dollars)

	Week Ending 2/4/81	$ Change Since Week Ago	$ Change Since Year Ago
Reserve Bank Credit			
U.S. Gov'ts and Agencies Owned Outright & RPs	125.476	– .251	+ 1.690
Loans to Depository Inst.	1.201	– .592	+ .443
Float	2.973	– .262	– 2.012
Total Reserve Bank Credit	139.558	– .634	+ 4.668
Treasury Deposits with Federal Reserve Banks	3.288	– .210	+ .312
Currency Outside Banks	117.184	+ .250	+ 7.821
Member Bank Reserves:			
Required	40.184	– .467	– 3.040
Excess (Deficiency)	.191	– .209	– .321
Total Reserves Held	40.375	– .676	– 3.361
Net Borrowed Reserves	.885	– .371	+ .755
Gov'ts held for Foreign Acct. by F.R. Banks (End-of-Week)	93.081	+ .054	+12.374

Monetary Aggregates†		% Change Since Three Months Ago*	% Change Since Year Ago
M-1A	366.9	– 18.1‡	– 0.2‡
M-1B	415.1	+ 2.2‡	+ 7.0‡
M-2 (December '80)	1,673.6	+ 7.3	+ 9.7
L (November '80)	2,346.5	+ 11.7	+ 9.8

†Seasonally adjusted. * Seasonally adjusted annual rate. ‡ Four-week moving average.

New York Money Market

Offering Rates 2/13/81	3 Months	6 Months	1 Year
‡U.S. Treasury Bills	15.56%	14.78%	13.54%
* Federal Agencies	16.00	15.90	15.00
* Project Notes—Taxfree (46% Taxable Equivalent)	11.57	12.50	13.89
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
* Secondary Market—Prime	16.00	15.00	

‡Finance Company Paper—Prime		‡* Bankers' Acceptances	
5- 14 days	16.00%	Mar.	16.65%
15- 59 days	16.25	Apr.	16.60
60- 89 days	15.75	May	16.50
90-119 days	14.75	Jun.	16.25
120-179 days	14.00	Jul.	15.90
180-270 days	13.00	Aug.	15.65

‡Industrial Paper—Prime		†Federal Funds	
30- 89 days	15.25%	Effective Rate	16.15%
90-120 days	16.00		

‡Discount basis. * Subject to availability. † Estimated.

Selected Business Indicators

(All Dollar Figures in Billions)

	Latest Period or End of Period	Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	4th Q'80 $ 2,741	$ 2,637	$ 2,496
Gross National Product (1972 Dollars)*	4th Q'80 $ 1,490	$ 1,472	$ 1,491
Percent Change, Annual Rate	4th Q'80 5.0%	2.4%	0.6%
Change in Consumer Prices (all urban consumers)*	Dec '80 13.2%	12.0%	14.4%
Change in Producer Prices*	Jan '81n 10.8%	6.0%	19.2%
Civilian Employment (Thousands of Persons)†	Jan '81 97,696	97,282	97,708
Unemployment as % of Civilian Labor Force†	Jan '81 7.4%	7.4%	6.2%
Personal Income*	Dec '80 $ 2,282	$ 2,260	$ 2,052
Leading Indicators Composite Index (1967=100)†	Dec '80 136.6	137.7	135.2
Industrial Production Index (1967=100)†	Dec '80 150.7	149.2	152.5
Net Change in Consumer Installment Credit†	Dec '80n $ 1.62	$ 0.84	$ 2.03
U.S. Merchandise Trade Balance†	Dec '80 –$ 2.06	–$ 0.79	–$ 2.87
Plant and Equipment Expenditures*	1st Q'81 $310.59(a)	$297.30(a)	$291.89
Private Housing Starts (Thousands of Units)*	Dec '80 1,548	1,563	1,548
New Construction Expenditures*	Dec '80 $ 241.6	$ 231.6	$ 244.0
Total Business Inventories†	Dec '80n $ 457.0	$ 458.0	$ 427.0
Total Business Sales†	Dec '80n $ 332.2	$ 329.0	$ 302.4

*Seasonally adjusted annual rate. †Seasonally adjusted. n-Newly reported figure. a-Anticipated.

measured by the GNP deflator—the picture worsens further, undermining the quality of earnings even more. However, this earnings decline is not nearly as sharp as the one in 1974 when earnings minus profits from inventories and underdepreciation plummeted by 26.9 per cent.

. . . In Many Industries

Profitability varied greatly between industries, depending on the influence of inflation, high interest rates, energy prices and regulatory developments. Benefiting from the partial decontrol of crude oil prices, as well as the sharp rise in world prices, oil companies recorded spectacular gains at the beginning of 1980. However, during the second half of the year, these increases began to fade, especially for those companies dependent on refining and marketing operations. Bulging inventories of oil and slumping demand for refined products such as gasoline, precluded refiners from fully passing higher acquisition costs onto consumers. Therefore, reduced profitability or in many cases outright losses in this area have more than offset higher profits from crude oil production.

At the other end of the profit picture was the automobile industry and many of its suppliers. The auto companies posted their worst earnings declines in history. In the fourth quarter, the automobile sector incurred another setback as sales declined again due to the resurgence in interest rates, increasing cost of gasoline and the reacceleration of inflation. ■

Short Term Paper Outstanding

(Millions of Dollars)

	Latest Week	Change Since Week Ago	Change Since Year Ago
Negotiable Time CD's Weekly Reporting Banks			
Nationwide (1/28/81)	117,656	+ 1,763	+24,962
New York City (1/28/81)	29,595	+ 301	+ 9,279
Commercial Paper (1/28/81)	130,457	– 150	+12,773

Bank Loans

(Millions of Dollars)

	Latest Week	Change Since Week Ago	Change Since Year Ago
	Commercial and Industrial Loans		
Weekly Reporting Large Commercial Banks			
Nationwide (1/28/81)	171,424	– 498	+13,516
New York City (1/28/81)	50,680	– 402	+ 3,684
	Total Loans Gross Adjusted		
Nationwide (1/28/81)	425,964	– 2,945	+27,890
New York City (1/28/81)	99,522	– 1,838	+10,149

Financial Markets

	Friday 2/13/81	Change Since Week Ago	Change Since Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	16.32%	+ .22	+ 3.56
180-Day Bills†	16.15	+ .65	+ 2.94
Longest Bills†	15.01	+ .46	+ 1.98
Recent Issues:			
13⅝s 1/31/82	14.50	+ .65	
13¼s 8/15/84	14.00	+ .50	
13s 11/15/90	13.62	+ .50	
12¾s 11/15/10	13.07	+ .32	
Municipals:			
Bond Buyer–20 Bond Index* (2/12/81)	9.99%	+ .09	+ 2.24
Blue List Total ($ Million)	$ 701	+ $ 94	– $ 34
30-Day Visible Supply ($ Million)	$2,246	– $ 72	– $ 130
Total	$2,947	+ $ 22	– $ 164
Corporates:			
Moody's Aa Composite (2/12/81)	13.78%	+ .06	+ 1.20
Money Mgr.–30-Day Supply ($ Million)	$4,088	+ $145	+ $2,840
Stocks:			
Dow-Jones Averages:			
Industrials	931.57	– 20.73	+ 46.59
Transportation	389.37	– 19.27	+ 102.17
Utilities	108.11	– 4.09	– 3.09
65 Stocks	361.04	– 11.97	+ 39.84
Standard and Poor's 500 Stocks	126.98	– 3.62	+ 11.57
N.Y.S.E. Composite Index	72.80	– 2.03	+ 6.66
N.Y.S.E. Avg. Daily Vol. for Week (000's)	37,074	– 8,310	– 16,880

* 46% Taxable equivalent 18.50%.

† Bond equivalent.

International Rates

	Friday 2/13/81	Week Ago
EURODOLLAR DEPOSIT RATES (bid)		
Overnight	17.38%	17.25%
1 month	17.88	17.56
3 month	18.25	17.44
6 month	18.19	16.88
1 year	17.06	15.81
EURODOLLAR BONDS Average Yield		
Medium Term (5 to 7 yrs.)	13.80%	13.20%
Long Term (7 to 15 yrs.)	13.60	13.05

FOREIGN EXCHANGE SPOT RATES New York Opening (2/13/81)	**U.S. $ Equivalent**	**Currency Per U.S. $**
Belgium	.02838	35.24
Canada	.8335	1.1998
Denmark	.1486	6.7300
France	.1975	5.0625
Germany	.4553	2.1965
Italy	.0009633	1038.00
Japan	.004864	205.60
Mexico	.04255	23.50
Netherlands	.4194	2.3845
Switzerland	.4984	2.0065
U.K.	2.2975	.4353

The Globalists . . .

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